IN THE HIGH COURT OF JUDICATURE AT MADRAS

DATED : 18.1.2007

Coram

The Honourable Mr.Justice P.D.DINAKARAN
and
The Honourable Mrs.Justice CHITRA VENKATARAMAN

T.C.No.311 of 2001

M/s.Sakhi Finance Ltd
Coimbatore ...Applicant

-vs-

Commissioner of Income Tax
Coimbatore ...Respondent

Tax Case filed under Section 256(i) of the Income Tax Act against ITA.No.3211/Mds/90 RA.No.302/1998 against the Order of the Commissioner of Income Tax [Appeals] Coimbatore dated 27.7.90 in Appeal NO.259-C/90-91 against the Assessment Order of Deputy Commissioner of Income Tax Special Grade I, Coimbatore dated 20.3.1990 dated 20.3.1990 in PAN.47-023-CZ-0166/87-88.

For Applicant : Mr.C.V.Rajan

For Respondent : Mr.Muralikumaran

JUDGMENT

(The judgment of the Court was delivered by
CHITRA VENKATARAMAN,J)

This reference is at the instance of the assessee filed under Section 256(1) of the Income Tax Act relating to the assessment year 1986-87.

2. The question of law that arises for consideration are as follows:-

1. Whether on the facts and in the circumstances of the case the Income-tax Appellate Tribunal was right in law in holding that the change in the system of accounting with regard to the receipt of additional finance charge to the cash basis cannot be allowed?

2. Whether on the facts and in the circumstances of the case the Income Tax Appellate Tribunal was right in law in not appreciating that the assessee had valid and

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bonafide reason for changing the method of accounting in regard to the additional financial charges?

3. Whether on the facts and in the circumstances of the case, the Income tax Appellate Tribunal was right in law in not following the decision of the Supreme Court reported in (1997) 227 ITR 172 and Madras High Court reported in (1975) 99 ITR 226, relied on by the assessee without stating why the said decisions were not applicable?

4. Whether on the facts and in the circumstances of the case the Income-tax Appellate Tribunal was right in law and had sufficient material to reverse the factual finding of the Commissioner of Income-tax (Appeals) that the settlement of the additional interest charged was through negotiations without the Tribunal itself examining this factual situation and bringing on record any material to substantiate its finding that the Commissioner of Income-tax (Appeals) was wrong?

5. Whether on the facts and in the circumstances of the case, the Income tax Appellate Tribunal was right in law in holding that merely because according to the agreement of finance the additional finance charges accrued the applicant was not entitled to change the method of accounting?"

3. The assessee is a finance company engaged in the business of hire purchase and leasing of assets. Till the assessment year 1986-87, the assessee was following the mercantile system of accounting for both finance charges and additional finance charges. However, from the assessment year 1987-88, while the assessee followed mercantile system of accounting as regards finance charges as before,with reference to the additional finance charges, it switched over to the cash system of accounting. Thus, the assessee effected a change in the method of accounting from mercantile system to cash basis as regards the additional finance charges. This resulted in the assessee not returning a sum of Rs.24 lakhs to tax on the ground that the same was not received in the year under consideration and it did not represent the income to be assessed for the year under consideration. The Assessing Authority rejected the claim for change of method of accounting and added the said sum in the assessment. Aggrieved assessee preferred an appeal before the Commissioner of Income Tax (Appeals).

4. The Appellate commissioner took the view that the circumstances under which the assessee changed his method of accounting on the overdue interest was bona fide, that overdue interest might be settled only through negotiation. He further felt that for the accrued interest offered

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for assessment, there was no manner of claiming the shortfall in the actual receipt of the overdue interest in the subsequent years. The commissioner also noted that the assessee also did not take credit for the interest under suspense account or under any other heads. Consequently, the first Appellate authority allowed the appeal directing the Assessing Authority to exclude a sum of Rs.24 lakhs from the assessment.

5. Aggrieved of this, the Deputy Commissioner of Income Tax filed an appeal before the Appellate Tribunal. Referring to clause 25 of the agreement, the Tribunal held that where a lessee committed default in the payment of lease rental, they were liable to pay the interest at 3% per month for the period of default and that such interest was payable immediately on receipt of notice of demand on the assessee. Consequently, the question of settlement through negotiation was not there. The Tribunal felt that without adverting to clause 25, the observation of the Commissioner of Income Tax Appeals to that extent was unsustainable.

6. Referring to the change in method of accounting, the Tribunal held that under Section 4 of the Income Tax Act, tax is charged in respect of the total income of the previous year of every assessee. It viewed that it was only the real income as commercially understood as earned by the assessee which has to be taxed. The Tribunal referred to the passage from the commentary on the Income Tax Act, by Kanga, 5th Edition, which is reproduced by the Supreme Court in the case of **STATE BANK OF TRAVANCORE v. CIT (158 ITR 102)**. The Tribunal held that even if the assessee had not made entries in the books of accounts, they could not escape the liabilities. It held that there was no reason why the assessee should be allowed to change the system of accounting in respect of interest receivable from the lessees on overdue payments. It held that change in system of accounting could not be allowed since it presented a distorted picture of profits and gains of business and the real income of the assessee could not be properly deduced from the changed method of accounting. Consequently, the Tribunal rejected the plea of the assessee and allowed the appeal by the Revenue. Aggrieved of this, the assessee has preferred this reference to this court on the questions stated above.

7. The learned counsel appearing for the assessee/ the applicant herein submitted that the Tribunal erred in rejecting the plea of the assessee. Placing reliance on the decision reported in **254 ITR 748 (CIT v. PONDI. INDL.PRO. DEVT. INVST. CORPN)**, wherein this Court answered the question in favour of the assessee following the decision of the Supreme Court reported in **(1999) 237 ITR 889 (UCO BANK v. CIT)**,learned counsel submitted that the Tribunal's view is totally incorrect and contrary to the law laid down by the apex court. He submitted that the decision of this Court in the case of **CIT v. ANNAMALAI FINANCE LIMITED** reported in covers the issue in full force. Consequently, the view of the Tribunal that change over from mercantile system to cash system presented a

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distorted picture of profits and gains of business, is totally unsustainable.

8. Per contra, the learned standing counsel appearing for the Revenue, apart from referring to the written submissions, placed reliance on the decision of the Supreme court reported in **158 ITR 102 (STATE BANK OF TRAVANCORE v. CIT)** and submitted that the decision reported in **237 ITR 889 (UCO Bank V. CIT)** has to be understood as relevant to banking institution alone. Hence , the question of extending the principle of the latter decision to the assessee's case did not arise. He further placed reliance on the decision of the Bombay High Court in **263 ITR 227(COMMISSIONER OF INCOME TAX v. MATCHWELL ELECTRICALS (I) LTD)** and submitted that considering the different fact situation, the decision of the Annamalai Finance Limited could not be extended to the facts of this case. He also placed reliance on the decision reported in **246 ITR 110 (CIT v. T.N.SMALL INDUSTRIES DEVELOPMENT CORPN. LTD)** to say that the law stated therein clearly applied to the present case.

9. A perusal of the decision of this Court reported in **275 ITR 451 (CIT v. ANNAMALAI FINANCE LIMITED)** shows that it related to a case of a finance company. The assessment related to the period 1992-93, 1993-94, 1994-95 and 1998-99. The Tribunal in that case upheld the change of method of accounting on overdue interest. The question raised in the reference was whether the Tribunal was right in upholding the change in the method of accounting on overdue interest alone on a cash basis, when the system of accounting of the assessee otherwise was mercantile. The tax case was concerned with other issues too, of which we are not concerned in the present case. Referring to the decision of the Bombay High Court reported in **(2003) 263 ITR 227 (COMMISSIONER OF INCOME TAX v. MATCHWELL ELECTRICALS (I) LTD)** and the decision of the Calcutta High Court reported in **(2003) 263 ITR 129 (HELA HOLDINGS PVT. LTD. v. COMMISSIONER OF INCOME TAX)**, this court summarised the general principle guiding on the question of change of method of accounting , which is as follows:-

> (i) the distinction between tax evasion and tax avoidance is still prevalent.
> (ii) generally speaking, tax evasion is the result of such things as illegality, suppression, misrepresentation and fraud.
> (iii) tax avoidance is the result of actions taken by the assessee, none of which is illegal or forbidden by the law in itself and no combination of which is similarly forbidden or prohibited.
> (iv) the permissibility of a tax avoidance, will fall to be decided, when and only on the basis of the facts and transactions truly and correctly disclosed by the assessee, a point of law arises, whether on a certain reasonable construction of one part of the taxing statute, as applied to the assessee's case, tax which

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would otherwise be payable by the assessee, becomes not payable in the case in hand.

(v) When the court is faced with a task of construction in the above manner, the court is not bound to make the construction in favour of the assessee merely on proof by the assessee, that it has entered into no illegality and made no prohibited transaction.

(vi) The court would have to assess, in the facts and circumstances of each case, upon general principles of conscience and justice, whether the arrangement of affairs by the assessee, so as to cause the possibility of a reduction of tax incidence, can fairly be permitted to the assessee, as a genuine and legal means of tax reduction, employed by it in a commercial fair sense, or whether allowing the assessee to earn the reduction, in the facts and circumstances of the particular case, is opposed to the public policy of not encouraging citizens to engage themselves in dealings and transactions designed primarily for the purpose of non-payment of tax only. (emphasis supplied).

10. Going by the principles, the Division Bench held that the Revenue was not in a position to satisfy that it suffered loss due to the change in the method of accounting. Referring to clause relating to the payment of additional overdue charges, this Court held that the terms of the agreement which enabled the assessee company to demand overdue charges, was only an enabling provision, which, by itself, did not guarantee the collection of the overdue charges. It held that it only gave a cause of action and that it would be very difficult to recognize income against overdue charges. Consequently, this Court affirmed the view of the Tribunal on the change of method of accounting on overdue interest on cash basis.

11. The facts prevailing in this case show that the situation is not different from the one prevailing in the decided case. But we are not just going by the similarity of the business carried on by the assessee in the reported case and in the case before us for consideration. A perusal of the decision of the Supreme Court reported in **237 ITR 889 (UCO BANK v. CIT)**, shows that the Apex Court had an occasion to consider the assessee following mixed method of accounting. The decision shows that the assessee therein credited a sum by way of interest to a suspense account since according to the bank, recovery of the said sum was doubtful. Hence, no recovery was effected for the last three years. Consequently, the assessee excluded the said sum while calculating the total income. Referring to the method of account, the Apex Court held at page 893 that,

> "The method of accounting which is followed by the assessee-bank is the mercantile system of accounting. However, the assessee considers income by way of interest pertaining to doubtful loans as not real

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> income in the year in which it accrues, but only when it is realised. A mixed method of accounting is thus followed by the assessee-bank. This method of accounting adopted by the assessee is in accordance with accounting practice....."

The decision also recognised the hybrid system of maintenance of accounts and the choice was left to the assessee to decide.

12. A perusal of Section 145 as it stood at the relevant time, shows that even where the accounts are maintained correctly and to the satisfaction of the assessing authority, where the method employed is such that the income could not be properly deduced, then it is open to the assessing authority to compute the income on such basis and in such manner as he may determine. The provisions of Section 145 was amended with effect from 01.04.1997 than it recognised only two methods of accounting, namely, cash or mercantile. Hybrid system of maintenance of accounts was a recognised mode atleast till the amendment was brought under Finance Act, 1995 w.e.f 01.04.1997. Whatever be the method of accounting, the assessing authority has the discretion to compute the income when the system of maintenance of accounts adopted by the assessee did not reflect the true income.

13. Referring to the decision reported in **158 ITR 102 (STATE BANK OF TRAVANCORE v. CIT)**, the Apex Court held that the said decision was given without reference to the circular dated 9th October 1984. The Apex Court further held that under the accounting practice interest which was transferred to the suspense account and not brought to the profit and loss account was not treated as income. The Apex Court pointed out that the Central Board had laid down a general test for deciding what was a doubtful debt and directed that the assessing authority should treat such amounts as not forming part of the income of the assessee until realised. In the facts of the case the Court held that the assessing officer was not right in taxing the interest in suspense account. The Apex Court explained the decision in **158 ITR 102 (STATE BANK OF TRAVANCORE v. CIT).**

14. The learned counsel appearing for the assessee referring to the decision emphasised that in the case on hand, additional overdue charges was attracted only as regards the defaulted payment. The fact that it had been continuously held on accrual basis and later on switched over to current year was only on account of difficulties faced by the assessee in realisation of the dues. Even on the principal amount and the interest carried thereon, he submitted that the assessee made entries in respect of expenditure on mercantile system of accounting. He also pointed out that if the accrued interest was offered for assessment, there was o manner of claiming the shortfall in the actual receipt of overdue interest in the subsequent years. He pointed out to the finding by the first appellate authority that the assessee did not take credit for this interest under suspense account or under other heads. on the fact as found by the

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Commissioner of Income tax, he did not take credit of this interest on the suspense account or under any other head. He also submitted that the difficulties in the realisation of the overdue interest on the default forced the assessee to change the method of accounting so that true picture on the computation of its income could emerge. He submitted that such change in the method was effected with all bona fides, since otherwise for it found that it had to offer assessment the interest income which it might not have received at all at the time of settlement of the hire purchase amount. He further submitted that the difficulties in recovery had only resulted in the change in the method of accounting. Consequently, the Tribunal was not right in ignoring the decision of the Supreme Court. He submitted that even though the said decision was in connection with the circular, yet, it must be noted that the Apex Court had taken note of hybrid system of accounting and had approved the same as one of the recognised method of accounts. He further pointed out that the unamendment Section 145 recognised hybrid method of maintenance of accounts. As such the amended provision could not be relied upon by the Revenue.

15. We agree with the submission made by the the learned counsel for the assessee. The reliance placed on b the learned counsel on the decision reported in **254 ITR 748 (CIT v. PONDI. INDL.PRO. DEVT. INVST. CORPN),** is correct. In fact, the Division Bench held that,

> 'The assessee cannot be held to be disentitled to change the method of accounting even when it is genuine solely on the ground that such a mixed system of accounting would result in loss to the Revenue for that year'.

16. The learned counsel appearing for the Revenue however strongly placed reliance on the decision reported in **158 ITR 102(STATE BANK OF TRAVANCORE v. CIT)** as well as to the decision of this Court reported in **246 ITR 110 (CIT v. T.N.SMALL INDUSTRIES DEVELOPMENT CORPN. LTD).** It must be seen that the decision reported in **246 ITR 110 (CIT v. T.N.SMALL INDUSTRIES DEVELOPMENT CORPN. LTD)** was based on **158 ITR 102(STATE BANK OF TRAVANCORE v. CIT).** Quite apart, the Division Bench of this Court held that in all the earlier references it was found that the assessee had been following the mercantile system of accounting consistently and that in the absence of anything to show that the assessee had followed different system of accounting claimed by the assessee, the same could not be accepted commonly. The learned counsel also placed reliance on the decision reported in **242 ITR 823 (T.N.SMALL INDUSTRIES DEVELOPMENT CORPN. LTD v. CIT).** We are concerned with the change in the method of accounting. The facts herein show that the shift in the method of accounting was bona fide, warranted by the circumstances as held by this Court in the case of Annamalai Finance Company. In view of the various guidelines to govern the issue, we do not find any merit in the submission of the learned

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standing counsel for the Department.

17. Since the right of the assessee to change the method of accounting was warranted by the needs of business and the relevancy of the situation, unless and until the Revenue is in a position to show that the real income could be siphoned out of the systems of the accounts maintained and thereby escape the net of taxation, we do not find any hesitation in answering the question in favour of the assessee. As rightly contended by the learned counsel for the assessee, the decision reported in **237 ITR 889 (UCO BANK v. CIT)**, as to the system of maintenance of accounts and to adopt cash system in the case of advanced packed charges, is not confined to a case of banking institutions only, and it has force in the case of institution engaged in finance transactions.

18. In the circumstances, we answer the questions of law in favour of the assessee and in the negative. No costs.

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Asst. Registrar.

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Sub Asst. Registrar.

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Sub Asst. Registrar.

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To
1. The Assistant Registrar,
Income Tax Appellate Tribunal,
Bench B, Rajaji Bhavan,
3rd Floor, Besant Nagar,
Chennai 90.

2. The Secretary,
Central Board of Direct Taxes,
New Delhi.

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3. The Commissioner of Income Tax(Appeals),
Coimbatore.

4. The Deputy Commissioner of Income Tax,
Coimbatore.

+ 1 CC To Mr. N.Muralikumaran, Advocate SR NO.3134

+ 1 CC To Mr. R.Vijayaraghavan, Advocate SR NO.2964

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